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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Amendment of Parts 32 and 64 of the	)	CC Docket No. 93-251
Commission's Rules to Account for	)	
Transactions between Carriers and	)	
Their Nonregulated Affiliates	)	

GTE's COMMENTS

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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Their Attorneys

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SUMMARY

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3. The sharing mechanism -- which was adopted merely as a backstop -- should not be cited to undermine the objectives of the Commission's plan for incentive regulation. The prevailing company price concept of the current rules provides an effective means of protecting the ratepayer by relying on the competence and self-interest of unaffiliated purchasers.

4. The costs of the "Asymmetric Rule" for services would be immense, far greater than any conceivable benefit, and it would do serious damage to Commission policy objectives.

5. GTE recommends adoption of a Rule providing that Affiliate Transactions would be deemed compliant with the prevailing company price Rule where aggregate sales of an unregulated affiliate to unaffiliated purchasers would come to a specified amount that is sufficiently "substantial" as to demonstrate a valid market price; or these aggregate sales, taken together with such additional factors as number of purchasers, growth in sales volume, the prices of competing offerings in the marketplace by unaffiliated vendors demonstrate a valid market price.

6. GTE agrees with the *Notice* that the impact of changes in affiliate transaction valuation methods and their associated increase in administrative costs must be given exogenous treatment for price cap exchange carriers.

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In the Matter of:	)	
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Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

GTE's COMMENTS

GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE") hereby submit comments in response to the Notice of Proposed Rulemaking, FCC 93-453 (released October 20, 1993) (the "*Notice*" or "NPRM") concerning the Commission's rules governing proper regulatory accounting under the Uniform System of Accounts ("USOA") for transactions between carriers and their nonregulated affiliates (the "Affiliate Transaction Rules").[1] These rules have been applied through the vehicle of specific line-by-line review of a Cost Accounting Manual ("CAM") for each Local Exchange Carrier ("LEC" or "exchange carrier") covered by the Affiliate Transaction Rules.[2]

GTE supports the submission concurrently herewith of the United States Telephone Association ("USTA") and adds the following specific comments.

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1 The Affiliate Transaction Rules have been included in Part 32 of the Uniform System of Accounts. *See* Separation of costs, CC Docket No. 86-111 ("D.86-111"), Report & Order, 2 FCC Rcd 1298 (1987); *modified*, Order on Reconsideration, 2 FCC Rcd 6283 (1987); *further modified*, Order on Further Reconsideration, 3 FCC Rcd 6701 (1988); *aff'd sub nom.* Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990) ("*Southwestern Bell*").

2 *See, for example*, *GTE's CAM* (AAD 7-1690), 3 FCC Rcd 3573 (1988), *supplemented*, 4 FCC Rcd 2205 (1989).

BACKGROUND

The Affiliate Transaction Rules seek to compensate for "faulty incentives" by "controlling the amounts carriers record in USOA accounts for affiliate transactions." *Notice* at paragraph 8. "Although the specified valuation methods are mandatory for federal accounting purposes, the rules neither regulate the prices at which affiliate transactions occur nor preclude the states from adopting different valuation methods for intrastate regulatory purposes." *Id.* at paragraph 4. The *Notice* (at paragraph 1) proposes to amend its rules to "enhance our ability to keep carriers from imposing the costs of nonregulated activities on interstate ratepayers, and to keep ratepayers from being harmed by carrier imprudence."

DISCUSSION

I. THE PROPOSALS OF THE *NOTICE* WOULD IMPOSE UNJUSTIFIED BURDENS AND CONSTRAINTS.

1. The proposed Rule changes would dramatically increase regulatory costs and burdens without improving the quality of relevant information made available to the Commission.

Without any real improvement in the quality of relevant information made available to the Commission, the proposed Rule changes would dramatically increase regulatory costs and burdens. Estimating the cost depends, among other things, on an assumed definition of "transaction" for purposes of the Rule, as well as extrapolating from GTE's experience with market appraisals and audits and detailed accounting to calculate likely costs. Taking these into account, GTE's estimate of the added costs for GTE that would be generated as a result of adopting the proposals and tentative decisions of the *Notice* is $11.5 million, of which $3 million would be directly associated with obtaining market valuations for services. GTE generally concurs with the concurrent submission of USTA addressing the question of cost on an industrywide basis.

In GTE's view, adoption of these proposals and tentative decisions would produce little, if any, additional relevant and useful information, and would produce little, if any, improvement in the quality (*e.g.*, accuracy) of relevant and useful information; and the immense cost could not conceivably be justified by results.

As shown *infra*, the effect of such an adoption would merely accumulate more and more detail with less and less relevance to the task of the Commission.

For example, the *Notice* (at paragraphs 77-81) proposes to require exchange carriers to estimate affiliate's transactions, monitor actual results, and true up those estimates on a quarterly basis, and to make the final true-up prior to the year end. GTE suggests that, as long as all proper adjustments are made by the time the ARMIS reports are duly filed, the timing and frequency of true-up mechanisms should be within the province of the carrier. Safeguards to be sure these adjustments are duly recorded exist within the "fairly presents" audit process -- which attests to the accuracy and integrity of the financial data reflected in these reports. Requiring more frequent true-ups would create a wholly unnecessary additional complication that will not provide either more or more accurate data that is relevant to anything the Commission is concerned with.

2. The proposed Rule changes follow the unfortunate pattern of more accounting requirements imposed just as the data produced thereby becomes less significant.

Enumerated in the submission of USTA are numerous safeguards against cross subsidy, ranging from Generally Accepted Accounting Principles ("GAAP") to CAMs to ARMIS reporting to independent audit requirements[3] to on-site audits to the influence of

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[3] The scope, complexity and cost of the independent audit requirement was greatly increased in Computer II Remand Proceedings, CC Docket No. 90-623, Report and Order, 6 FCC Rcd 7571 (1991), *petitions for review pending sub nom.* California v. FCC, No. 92-70083 (9th Cir. filed February 4, 1992). This audit requirement will be still further extended under the *Notice* at paragraph 98.

the marketplace. The totality of these safeguards subject exchange carriers to searching, detailed and continuous scrutiny. And yet, the Notice proposes and recommends the creation of still another level of accounting requirements.

As shown *infra*, just as the significance of detailed accounting data is reduced dramatically by virtue of (i) increased competition and (ii) the price caps program, the *Notice* would impose more burdensome accounting requirements. The imposition of these additional burdens is wholly unjustified and would produce effects directly counter to established Commission policy.

3. As competition increases, there is a critical need for reduced regulatory burdens on exchange carriers, not increased burdens.

In the case of AT&T, the Commission has taken appropriate action to reduce regulatory burdens with increasing competition.[4] Recently, the Commission took steps in that direction for exchange carriers[5], *i.e.*, that the introduction of broadened competition must entail measures that permit exchange carriers to compete.[6]

The reality of exchange competition has been well and thoroughly demonstrated. A new report by Moody's Investors Service observes that the competitive risk at the

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4 Competition in the Interstate Interexchange Marketplace, Report and Order, CC Docket No. 90-132, 6 FCC Rcd 5880, 5881-82 (1991).

5 Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141 ("D.91-141"), Second Report and Order and Third Notice of Proposed Rulemaking, FCC 93-379 (released September 2, 1993) (the "*D.91-141 Phase I Order*").

6 "[I]n order to encourage efficiency and full competition", the *D.91-141 Phase I Order* says, exchange carriers "should -- indeed must -- be allowed to offer" reasonable volume and term discounts." *D.91-141 Phase I Order* at paragraph 115, footnote omitted, emphasis added. Further, it says: "As a general matter, if volume and term discounts are justified by underlying costs, and are not otherwise unlawful, the LECs should -- indeed must -- be allowed to offer them in order to encourage efficiency and full competition." *Id.* at para. 115, footnote omitted.

local loop level has increased "significantly," and the debt ratings of exchange carriers "are likely to be downgraded as a result."[7]

Some time ago, an extended study by Peter Huber, Michael Kellogg, and John Thorne pointed out:

> CAPs are now operating in so many cities and suburbs that it is difficult to keep a complete count. These include 24 of the top 25 metropolitan service areas, and the cities and regions they serve contain the headquarters of approximately 70 percent of the companies that appear on the Communications Week 100 list.[8]

In the largest metropolitan areas, CAPs have already taken substantial shares of the markets they have targeted. Bell Atlantic, for example, was able to demonstrate two years ago that it had already lost nearly 50% of the DS-3 market in the Washington metro area. In some cities, as many as five CAPs have already entered the market. And CAP market entry is no longer confined to the largest cities.[9]

Geodesic Network II also documents the extensive alliances and/or mergers between cable television companies and CAPs.[10] It notes: "Overall, cable interests now control over 50 percent of CAP revenues. Spurred by the promise of their new

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7 *See* "Moody's Warns That Mergers, Emerging Local Exchange Competition Will Hurt Telco Debt Ratings," TELECOMMUNICATIONS REPORTS, December 6, 1993, at 5.

8 Peter W. Huber, Michael K. Kellogg, and John Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry*, ("*Geodesic Network II*") at 2.25.

9 CAP fiber rings are now operating in Fort Wayne, Indiana, and Grand Rapids, Michigan. Fiber is also stretching into suburban areas surrounding cities where CAPs have already established themselves. Both Teleport and MFS, for example, are extending their Dallas networks to reach customers in the Las Colinas area. New fiber entrants add to existing, and growing competition from microwave and VSAT systems.

10 *Geodesic Network II* at 2.58-63.

alliances, cable-CAP companies are now deploying fiber-optic cable at record rates."[11] Made public in the last few weeks have been even more extensive and significant alliances of this sort .

Cable networks already pass the vast majority of households in the United States, and technology is already available which will allow these networks to provide telephone service at relatively low cost. A recent study by David P. Reed of the FCC's Office of Plans and Policy estimates that a cable network could be modified to provide switched narrowband telephone service at a cost of $207 per subscriber.[12]

Cellular services are already widely available today, and the Commission has recently announced plans to make available spectrum for Personal Communication Service ("PCS"). A recent study of one of GTE's rural exchanges in Wisconsin found that cellular service was available throughout the exchange at rates which were competitive with GTE's landline rates for the actual calling patterns of many local subscribers -- including low volume residence and business customers.[13]

Finally, perhaps the strongest indication that exchange carriers are now driven by the market rather than by regulation, and that the need for detailed information to protect the ratepayer is rapidly disappearing, is that GTE's pricing is generally below the level allowed by the price cap rules.

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[11] *Id.* at 2.59.

[12] David P. Reed, "The Prospects for Competition in the Subscriber Loops: The Fiber-to-the-Neighborhood Approach," at 4. Presentation made at Twenty-First Annual Tele-communications Research Policy Conference, Solomons Island, Maryland, September 1993. Scientific-Atlanta Inc. has just announced the availability of equipment for this purpose. Scientific-Atlanta also quotes a cost per subscriber of "about $300," which is close to Reed's estimate. *See* "Scientific-Atlanta's New Device to Allow Phone Calls Using Cable-TV System," Wall Street Journal, Monday, November 15, 1993 at B6.

[13] Edward C. Beauvais, "Local Exchange Service: What Bottleneck?" USTA TELETIMES, Spring 1993, at 2.

The marketplace is making regulatory constraints academic. This supports the wisdom of the Commission's policy determination, discussed further *infra*, to adopt incentive regulation and move away from rate of return regulation. But the *Notice* points in the opposite direction. As exchange competition increases, as regulatory constraints become academic and the mass of data associated therewith becomes less useful, the *Notice* would dramatically increase regulatory burdens.

GTE urges the Commission to reject this out-of-date approach to regulation which would impose unnecessary and costly increases in accounting requirements. As shown *infra*, this approach would only serve to undermine established FCC policy. The Commission should be particularly wary of burdens imposed on LECs but not on their competitors, since the result can be not a real increase in competition but merely the award of market shares to new entrants by regulatory fiat.

4. The objectives of the Commission's price cap plan must not be undermined by citing the sharing mechanism, which is merely a backstop device.

With the price for service being established by the marketplace, as stressed *supra*, why should the Commission require an ever-increasing investment of price caps carriers in complying with detailed accounting requirements over and above those that presently exist? The *Notice* (at paragraph 103) seeks to justify dramatically increased accounting burdens for price cap companies by referring to the need to "determin[e] the

LECs' sharing obligations." Sharing, adopted as a backstop mechanism, was never intended to compromise the carefully delineated objectives of incentive regulation.[14]

Price caps represents an innovative approach to regulation. It is designed to assure protection of the public interest while avoiding the pointless complexities and irrational consequences of the rate of return system. In 1989, the Commission said: "Our interest in formulating an alternative regulatory approach for dominant carriers stems directly from our concern with the drawbacks of rate of return regulation."[15] Measuring alternative regulatory methods against the rate of return system, the Commission identified five flaws in rate of return regulation: (1) it provides incentives for carriers to be inefficient; (2) it provides carriers with insufficient incentives to encourage innovation; (3) it tends to foster cross-subsidization and inability to move toward an optimally efficient set of prices; (4) its administrative costs are high; and (5) consumers are better off under incentive regulation than under rate of return regulation.[16]

The price cap plan was fashioned, in the course of several years of consideration, to avoid these five flaws associated with rate of return regulation. It must be stressed that the sharing device was carefully described as simply a "backstop"[17] --

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[14] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989), and Erratum, 4 FCC Rcd 3379 (1989), ("*D.87-313 Report & Order*"), Second Report and Order, 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), ("*LEC Price Cap Order*"), *modified on recon.*, 6 FCC Rcd 2637 (1991) ("*LEC Price Cap Reconsideration Order*"), *aff'd. sub nom.* National Rural Telecom Association, 988 F.2d 174 (D.C. Cir. 1993).

[15] *D.87-313 Report & Order*, 4 FCC Rcd at 2922.

[16] *Id.*, 4 FCC Rcd at 2922.

[17] *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2683-84; *LEC Price Cap Order*, 5 FCC Rcd at 6801.

not as an inversion of the entire plan and a return to the very irrationalities the plan was constructed to escape. An approach that, in the name of a mere backstop, leads FCC regulation right back to these five flaws would collide with the clear intent of the Commission's own policy.

Since the sharing provision does not lead to refunds but only to a revision in the PCI for the next year,[18] and since GTE's rates (as stated supra) are generally below price cap levels, it cannot be assumed that sharing will have any impact on GTE's rates. In terms of eventual effects, it should be remembered that sharing was designed to protect carrier investors as well as ratepayers, so sharing might ultimately lead to increased rates. In any case, the Commission must make certain this secondary device, sharing, is not permitted to defeat the core of the price caps plan.[19]

The proposals of the *Notice* that would dramatically increase accounting requirements for price cap companies conflict with the whole thrust of Commission policy centered on incentive regulation. They would engage the Commission staff and company accountants not only in the same exhaustive accounting effort as if price caps did not exist, but in an even more extensive effort to gather detailed accounting data even though the likelihood that that data will have any significant bearing on rates is far less than ever before.

GTE suggests the proposals and tentative decisions of the *Notice* should be subjected to searching scrutiny in relation to the Commission's constructive and forward-looking policy of incentive regulation. Such an examination must lead to

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18 "[T]he sharing mechanism operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings...." *LEC Price Cap Order*, 5 FCC Rcd at 6803.

19 Under price caps, it is improper even to speak of overearnings. Earnings over the upper threshold are shared with the customers through adjustments in the PCI.

rejection of these proposals and tentative decisions and a return to the spirit of the price caps plan.

Moreover, the *Notice* (at paragraph 9) says, based on analysis of the present Rules, "we believe the present mix of valuation methods may not be optimal for protecting ratepayers against cross-subsidization."

GTE submits that there has been no demonstration that the current rules, combined with the FCC's active program of enforcement, do not provide sufficient protection for the ratepayer. Surely the adoption of far more burdensome regulations must be grounded on identified problems that have arisen rather than a feeling that present rules "may not be optimal."

5. GTE urges the Commission to reject those proposals of the *Notice* that would impose more severe and burdensome requirements just as the need for detailed accounting requirements diminishes by virtue of price caps and competition.

In summary: GTE urges the FCC to reject the proposals and tentative conclusions of the *Notice* making changes in the Commission's Rules that would dramatically increase regulatory costs and burdens without improving the quality of relevant information made available to the Commission. The Notice would require generation of more and more regulatory accounting data just as, under price caps, that additional data are becoming less and less significant. As competition increases, there is a critical need for reduced regulatory burdens on exchange carriers, not increased burdens. The sharing mechanism -- which was adopted merely as a backstop -- should not be cited to undermine the objectives of the Commission's plan for incentive regulation.

II. THE NPRM's PROPOSALS ON PREVAILING COMPANY PRICE WOULD IN EFFECT ELIMINATE A POTENTIALLY VALUABLE AND LESS BURDENSOME WAY OF PROTECTING THE RATEPAYER.

1. The prevailing company price concept of the current rules provides a means of protecting the ratepayer by relying on the competence and self-interest of the unaffiliated purchaser.

Under the prevailing company price concept of the current Rules, the focus is on the unaffiliated purchaser.[20] The fair assumption is made that corporate purchasers acting in the interests of their firms are likely to be knowledgeable about the product-price mix available on the market, to be motivated to find the mix most suitable to their firms' objectives, and to be able to make competent decisions in this direction.

Suppose: (i) an unregulated affiliate of an exchange carrier (designated *UNREG*) sells to forty unaffiliated parties twenty million dollars worth of its sole product, P, at a price of ten dollars per unit, all transactions being for amounts that are not trivial[21] and no single purchaser being predominant, and (ii) *UNREG* sells P to its affiliated LEC at a price of ten dollars per unit. Transactions of these dimensions would be "substantial" by any definition that relates to the purpose of the Rule, *i.e.*, it would be a sufficient amount to prove that there would be no "harm to the ratepayer"[22] because the ratepayer is getting the benefit of a product, P, whose product-price mix is shown to be competitive at ten dollars, and the sale price to the affiliated LEC is ten dollars.

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[20] *See U S West's CAM*, 4 FCC Rcd 481, 486 (1989) (Chief, Common Carrier Bureau): "Because unaffiliated persons and entities will have no incentive to subsidize U S West's operations, the prices should be sufficient to cover U S West's costs." Footnote omitted.

[21] The amount purchased, to be given weight, would have to be enough to justify an assumption that a competent purchaser would have evaluated the market, and based its decision on the range of product-price offerings available.

[22] That "no harm to the ratepayer" is the standard applied is evidenced by, for example, a letter of the Chief, Accounting and Audits Division, dated November 15, 1993, addressed to Cincinnatti Bell and authorizing proposed treatment of CDAR investment.

Applying the perfectly sound logic the Commission was following when it adopted its Affiliate Transaction Rules, these facts would establish the legitimacy of the transactions.

But these perfectly legitimate transactions would be recognized to justify the ten dollar price to the affiliated LEC under the prevailing company price standard proposed by the *Notice* (at paragraph 19 and 22) **only** if selling P to unaffiliated parties represents *UNREG*'s "primary business" – and for this determination a definition is to be used: unaffiliated sales of P must be seventy-five percent of *UNREG*'s sales of P.

What is the logical connection between the prevailing company price concept and the seventy-five percent test? It must be stressed that the prevailing company price concept **looks at the unaffiliated purchasers** and bases its judgment on reasonable assumptions about how purchasers in the business world behave. The seventy-five percent test, by contrast, **looks at the business of *UNREG*** and imposes a test that has no relationship whatever to the motivation or competence of those forty buyers spending twenty million dollars -- buyers whose behavior is not in the slightest influenced by whether *UNREG*'s sales of P to unaffiliated parties is seventy-five percent of total sales or one percent of total sales.

The *Notice* (*id.*) offers no connection between the logic of the prevailing company price Rule and the proposed seventy-five percent test. It simply pronounces a tentative conclusion that a given percentage is appropriate to link two totally unrelated concepts. Its purpose appears to be to eliminate the prevailing company test as a practical matter without formally eliminating the Rule.

The prevailing company price concept can provide reasonable protection for the ratepayer without the rigidities and economic irrationalities the Commission sought to escape in adopting price caps. This concept is far more suitable to a regulatory environment where the decision has been made to step back from rate of return regulation. In contrast, mandating the assembly of still more massive amounts of data -

- which then must be more extensively covered by independent auditing firm certification[23] -- expends industry and agency resources to provide data that is generally irrelevant to the role the Commission is playing – and indeed increasingly still more lacking in relevance as the industry leaves far behind a closed-market environment and as traditional regulatory accounting issues lose significance.

In summary: The prevailing company price concept of the current rules provides an effective means of protecting the ratepayer by relying on the competence and self-interest of the unaffiliated purchaser.

2. GTE suggests an approach to assuring pricing validity employing the prevailing company price concept.

In GTE's view, any test devised to assure protection of the ratepayer should reasonably relate to the logic of the prevailing company price standard. The dimensions of the sales to unaffiliated parties is relevant, as is (i) the number of *bona fide* purchasers for amounts that are not trivial and (ii) the growth in sales volume.

Also relevant is data on what is generally offered in the marketplace by unaffiliated vendors – but the FCC has not willing to give any weight to this kind of

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[23] *See* the *Notice* at paragraph 98.

data[24] which is already being generated for purposes of state regulation. All of these criteria at least have a reasonable relationship to what is being considered: whether the marketplace is providing evidence showing the competitive validity of the product-price offering to the affiliated LEC.

From the point of view of the company, an important consideration is that any test adopted should provide reasonably understandable, objective and predictable results. This is because by its nature such a test would have an important bearing on the long-term planning of the company. In contrast, the Commission's accounting arm is by definition not engaged in making decisions with long-term consequences; it is simply reviewing the results of the company to assure compliance with the Commission's Rules. Any test fashioned for this purpose, then, should be designed to provide a "safe harbor" for the company, *i.e.*, assurance that, if the LEC's figures come within certain parameters, the validity of the pricing will be accepted.

In summary: In terms of the example, *supra*, GTE recommends adoption of a Rule providing that Affiliate Transactions would be deemed compliant with the prevailing company price Rule where aggregate sales of *UNREG* to unaffiliated

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[24] In D.86-111, the Commission was emphatic in rejecting as "a measure of value ... the value of similar services in the marketplace" on the grounds that such a standard would be "fraught with the potential for abuse, and ... difficult to monitor." Order on Reconsideration, 2 FCC Rcd at 6297. The Bureau has stressed many times that the only market-related standard to be applied is the prevailing company price standard. *See Centel's CAM*, 4 FCC Rcd 3913, 3913-4 (1989) (Chief, Common Carrier Bureau); *Lincoln Telephone's CAM*, 4 FCC Rcd 4755 (1989) (Chief, Common Carrier Bureau); *NYNEX Telephone Companies*, 3 FCC Rcd 5978, 5980-81 (1988) (Chief, Common Carrier Bureau); *Rochester Telephone's CAM*, 4 FCC Rcd 4567 (1989) (Chief, Common Carrier Bureau); *Southwestern Bell Telephone's CAM*, 4 FCC Rcd 3388, 3390 (1989) (Chief, Common Carrier Bureau); *U S West's CAM*, 3 FCC Rcd 195, 198-99 (1988) (Chief, Common Carrier Bureau); *United Telephone's CAM*, 4 FCC Rcd 2407 (1989) (Chief, Common Carrier Bureau). The *Notice* contains no explanation of how a standard totally unacceptable heretofore because of its unreliability can now be imposed on LECs on a mandatory basis.

purchasers would come to a specified amount -- certainly not more than a million dollars -- that is sufficiently "substantial" as to demonstrate a valid market price; or these aggregate sales, taken together with the additional factors enumerated *supra* (number of purchasers, growth in sales volume, the prices of competing offerings in the marketplace by unaffiliated vendors) demonstrate a valid market price.

III. THE *ASYMMETRIC RULE* APPLIED TO SERVICES WOULD CREATE VAST ADMINISTRATIVE PROBLEMS AND WOULD CONSTITUTE STILL ANOTHER *AFFILIATION PENALTY* THAT COULD AMOUNT TO DENYING CUSTOMERS THE IMPORTANT BENEFITS OF PROPER AFFILIATE RELATIONSHIPS.

1. The costs of the *Asymmetric Rule*" would be immense, the benefits negligible, and the damage to Commission policy objectives devastating.

The *Notice* (at paragraph 34) tentatively concludes the Commission should adopt what would amount to an entirely new Rule for services which -- except for LEC tariffed offerings and prevailing company price cases[25] -- would require the LEC for both assets and services to treat a transaction on either a cost or fair market value basis -- whichever is the more unfavorable to the investor.[26] This GTE will refer to this as the "*Asymmetric Rule*" since the Rule will produce an asymmetric result. Is the investor-ratepayer relationship a zero sum game in which the ratepayer benefits as the investor loses? Absolutely not. This rule would impose a real penalty on the investor without being likely to provide any benefit to the ratepayer, for the reasons discussed *supra*. Indeed, there is no reason to believe ratepayers will realize any incremental

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25 As indicated *supra*, the seventy-five percent Rule would be likely to preclude prevailing company price as a practical matter.

26 "[W]e tentatively conclude that we should require carriers to record all affiliate transactions involving the provision of services, other than those provided pursuant to tariff or permitted to be recorded at prevailing company prices, at the higher of fully distributed costs and estimated fair market value when a carrier is the seller, and at the lower of fully distributed costs and estimated fair market value when a carrier is the purchaser." *Notice* at paragraph 34.

benefit whatever from the *Asymmetric Rule*, given the reality that GTE is, as stated *supra*, at pricing levels generally below its price cap levels.

How can we assess the cost implications of such a Rule? Compliance with this Rule would entail a continual process of market-based appraisal concurrently with the full range of affiliate transactions. As stated *supra*, GTE estimates at $3 million the annual cost of obtaining certified market valuations for services, while the annual in-house costs associated with this activity are estimated at $ 4 million.[27]

The costs of such a Rule on an industry basis would be staggering. What would be the benefits? Even making the (bad) assumption that the interests of ratepayers amount to simply lower rates[28], it cannot be expected that this vast expenditure would produce lower rates for ratepayers. Further, the relative burden borne by exchange carriers compared to their competitors would be further increased just at a time when competition is increasing. The resources of the Commission would be diverted from more productive activity. And another step would be taken toward undermining the whole logic of incentive regulation.

As pointed out *supra*, the Commission itself has long rejected employment of any market-related test apart from prevailing company price.[29] Now the *Notice* signals an abrupt change of course. The very test it found unacceptable it will impose on exchange carriers. There is no logic in the Notice supporting any such action.

In *Southwestern Bell*, the D.C. Circuit upheld a form of the Asymmetric Rule that applied only to assets, while the Rule of the *Notice* applies not just to "assets" but to

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27 The aggregate of $ 7 million ($3 million plus $ 4 million) forms part of GTE's overall estimate of $11.5 million, *supra*.

28 It is well established that, if the investor's realized return becomes uncompetitive in relation to other investment opportunities of comparable risk, the enterprise either will be unable to obtain needed capital or will have to suffer the effects of more expensive capital, all of which will adversely affect the interests of ratepayers.

29 *See* n. 24 *supra*.

"services" as well.[30] The nature of the Rule of the *Notice*, and the different circumstances and impact that will be associated with it, require this case to be distinguished. Transactions involving "assets" are relatively rare and typically of limited impact. By contrast, the Asymmetric Rule now proposed would apply to the universe of Affiliate Transactions. While application of such a Rule to assets would be most unlikely ever to involve questions of confiscation, the Asymmetric Rule now proposed would place the Commission' s accounting Rules squarely in the middle of a vast number of "services" transactions with very substantial amounts of money at risk.

Moreover, this Rule expresses and seeks to enforce -- without explicit acknowledgement -- a concept foreign to the whole purpose and intent of the Affiliate Transaction Rules heretofore. Until now, the Commission's inquiry was simply whether the ratepayer was "harmed" by the action in question. *See, for example*, n.22 *supra*. Now it becomes a question of the Commission seeking to obtain for the ratepayer -- or, more correctly, deny to the investor -- something additional, over and above what would assure no harm to the ratepayer.

The cumulative result of these Affiliation Penalties would be to place an exchange carrier's unregulated affiliate at a grave disadvantage vis-a-vis unaffiliated parties. The unintended effect of this accumulation could be denying ratepayers the benefits of proper affiliate relationships. Indeed, the imposition of the plethora of entirely new and complex accounting requirements proposed by the *Notice* is intelligible only if it is assumed that a policy decision has been reached that disfavors affiliate relationships.

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30 As the terms are generally understood under the current Rules in the context of Affiliate Transactions, "assets" refer to tangible investment recorded in operating accounts, typically property, plant or equipment, while "services" include what is usually referred to as "goods", *e.g.*, inventory.

But no decision has ever been made by the FCC that affiliate relationships are for some reason undesirable. The employment of unregulated affiliates has been shown to generate great savings and benefits.[31] These can arise from the economies of scale inherent in the provision of service by a centralized provider, including the employment of experts who can learn lessons of broader application as they deal again and again with similar problems at many separate locations. Having this expertise available to the individual exchange carrier can free its management to concentrate on more urgent matters or on activities more central to its core business interests. Further, the implementation of "system standards" can produce the very important economy of being able to address the same essential situation at ten or twenty or fifty locations across the country, using the expertise developed at one or two locations.

Further economies of scale can be obtained in the procurement of materials and supplies, where aggregating the purchases of the entire system can generate volume-related price reductions and reduced inventory carrying costs, as well as other favorable contract terms. Procurement of complex systems designed or modified to meet an exchange carrier's particular needs becomes practical for a company that is a large enough purchaser of systems. In contrast, small companies have to make do with whatever vendors produce to meet the demands of the big purchasers.

There are other important benefits of affiliate relationships. Standardized management systems can be employed on a system-wide basis to deal with, for example, maintenance of inventories. Compliance with government regulations is another notable area where there are important economies of scale involved.

Whether it is a matter of equal employment opportunity, antitrust regulations, new requirements affecting operator services or 900 services, environmental regulation, or whatever, the expertise of lawyers and administrators and engineers to

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[31] GTE has demonstrated these benefits in countless state proceedings.

deal with and solve -- or better still anticipate and prevent -- failures to comply with government requirements gained in Illinois can be to a great degree applied in California, in Florida, in Texas. Even when regulations vary by state, having dealt with comparable regulations elsewhere can be an important asset. Evidence of this is found in the pattern of FCC action, where much more demanding regulations are applied to the large or the very large companies with centralized staffs than to smaller companies. This is true with regard to formal FCC action[32], and it carries even more weight with regard to the less formal realities, *i.e.*, in terms of whether there is actual enforcement of the regulations. This difference in the severity of rules as written and applied by the FCC itself recognizes that companies with a centralized staff realizing the economies of scale discussed *supra* are better able to meet compliance requirements at reasonable cost.

Without any conscious decision to produce such a result, ever-heavier burdens imposed in the name of regulation may finally amount to elimination of Affiliate Transactions that offer many solid and proven benefits. This is not far-fetched. It must be recalled that AT&T, faced with the need to make a choice, chose the competitive market rather than continue under the constrictions of federal and state exchange carrier regulation.

As a related matter, the *Notice* (at paragraphs 37-39) raises the possibility that the Commission's standard might not be satisfied by a showing that the net effect of an affiliate transaction exceeds the mandated level, *i.e.*, provides a subsidy.

The Commission's focus in writing and applying these Rules should continue to be no harm to the ratepayer. *See* n.22 *supra*. Once this has been shown, the

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[32] Examples include equal access regulations; requirements affecting 800 access service; and of course the CAM-related requirements here under discussion.

Commission's inquiry should be at an end. Otherwise, the Affiliate Transaction Rules could amount to an open-ended challenge unrelated to the purpose of the Rule.

In summary: The costs of the Asymmetric Rule would be immense, far greater than any conceivable benefit, and it would do serious damage to Commission policy objectives.

IV. GTE AGREES WITH THE NOTICE THAT THE CONSEQUENCES OF CHANGES TO THE USOA SHOULD BE GIVEN EXOGENOUS TREATMENT.

In adopting incentive regulation[33], the Commission defined exogenous costs as follows:

> Exogenous costs are in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers. ... These costs are created by such events as separations changes; USOA amendments; changes in transitional and long term support; the expiration of amortizations; and the reallocation of regulated and nonregulated costs.[34]

Further, the D.87-313 Second Report said:

> Changes in LEC costs that are caused by changes in Part 32 of our Rules, the Uniform System of Accounts (USOA), will be considered exogenous. We make this classification on the basis that such changes are imposed by this Commission and are outside the control of carriers.[35]

In the *Notice* (at paragraph 36), the Commission says:

> The valuation methods we propose in this *Notice* would change the USOA requirements for affiliate transaction accounting. In the price cap proceedings, the Commission determined that changes to the USOA

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[33] *Policy and Rules Concerning Rates for Dominant Carriers,* Second Report and Order, CC Docket No. 87-313 ("*D.87-313*"), Second Report and Order ("*D.87-313 Second Report*"), 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), *modified on recon.*, 6 FCC Rcd 2637 (1991), *aff'd. sub nom.* National Rural Telecom Association, 988 F.2d 174 (D.C. Cir. 1993).

[34] *D.87-313 Second Report*, 5 FCC Rcd at 6807.

[35] *Id.*, footnotes omitted.

> should generally be treated as exogenous. In view of that determination, we tentatively conclude that any changes we make in the valuation methods for affiliate transactions should be exogenous.[36]

GTE concurs. When the Commission makes changes to the affiliate transaction valuation methods the total impact of such changes should be treated as exogenous for price caps purposes. This treatment includes not only the changes brought about by the valuation methods themselves, but also includes the increased recurring administrative costs that are attributable to those changes. Clearly the increased recurring administrative costs are just as "outside the control of carriers" as the valuation impacts themselves.

In summary: The impact of changes in affiliate transaction valuation methods and their associated increase in administrative costs must be given exogenous treatment for price cap exchange carriers.

Respectfully submitted,

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[36] Footnotes omitted.